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IN THE
Supreme Court of the United States
OCTOBER TERM, 1993

COLGATE-PALMOLIVE COMPANY,
Petitioner,

v.

FRANCHISE TAX BOARD,
An Agency of the State of California,
Respondent.

On Petition for a Writ of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

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SUPPLEMENTAL BRIEF OF PETITIONER

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RULE 29.1 STATEMENT

The changes to the Rule 29.1 Statement since the filing of Colgate-Palmolive Company's petition for certiorari are listed in the Appendix to this supplemental brief at App. B at 3a.*

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* All references to the Appendix in this brief are denominated "App." followed by a unique letter and a page reference.

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SUPPLEMENTAL BRIEF OF PETITIONER

INTRODUCTION

Two recent developments bearing on this case have precipitated the filing of this supplemental brief by petitioner Colgate-Palmolive Company (hereafter "Colgate") pursuant to Rule 15.7. First, on October 6, 1993, the Governor of California signed legislation enacted a month earlier modifying California's approach to taxing the income of a multinational group of corporations. Second, on October 7, 1993, the Solicitor General filed an amicus brief in *Barclays Bank PLC v. Franchise Tax Bd.*, No. 92-1384—a case closely related to this one—recommending that the Court deny certiorari in *Barclays* on the ground that the recent California legislation obviated the necessity of Supreme Court review.

As we demonstrate below, neither the recent California legislation nor the views of the Solicitor General expressed in *Barclays* diminish the need for this Court to address the issues of profound national and international significance raised by this case. Even assuming that the recent California legislation renders California's tax scheme constitutionally unobjectionable for future years, it leaves undisturbed billions of dollars of tax liabilities for hundreds of taxpayers who are being compelled to report their income on a worldwide combined basis. *See infra* pp. 3-5. In any event, the purported cure for the ills of California's taxing regime is more apparent than real. *See infra* pp. 5-7. Furthermore, rather than providing any sound basis for denying certiorari in *Barclays* (and, by inference, in this case as well), the Solicitor General's brief strongly reinforces the case for granting certiorari.

1. *The recent California legislation.* For tax years beginning on or after January 1, 1994, California Senate Bill 671 (Oct. 6, 1993) modifies the state's treatment of a multinational group of corporations for franchise tax purposes in three principal respects. First, the legislation removes the fee that corporations were required to pay under preexisting law if they wished to limit combined reporting of their income to a "water's-edge" group, *id.* §§ 24, 26, *i.e.*, to certain domestic corporations and to foreign corporations conducting substantial activity in the United States. *See* Cal. Rev. & Tax. Code § 25110(a) (West 1992).[1] Second, the legislation removes the authority the Franchise Tax Board possessed under certain circumstances to disregard a corporation's water's-edge election and to require it to file on a worldwide combined basis. Cal. S.B. 671, §§ 16, 23. Instead, additional penalties and record retention requirements apply to all corporate taxpayers, not just those making the election. *Id.* § 16. Third, the legislation eliminates the Domestic Disclosure Spreadsheet, which corporations making a water's-edge election were required to file under pre-existing law, and requires instead that certain large corporations file a list of 20-percent-or-more-owned affiliates. *Id.* § 13.

[1] California originally enacted this legislation in 1986 to take effect on January 1, 1988. The legislation permits a corporate taxpayer engaged in a worldwide unitary business to compute its California franchise tax liability generally on the basis of its United States, as opposed to its worldwide, operations.

2. *The Solicitor General's amicus brief.* The Solicitor General's amicus brief recognizes that

> [t]he United States has long taken the position that California's application of the worldwide combined reporting method to corporations doing business in California that have foreign parents or foreign affiliates is inconsistent with the "separate accounting" or "arm's length" method under federal law and under established international practice.

S.G. Br. at 4.[2] The Solicitor General further observes that the United States has expressed its concern that "state use of worldwide combined reporting was 'at odds with the position of the United States and has become a source of conflict with foreign states.'" *Id.* (quoting Pet. App. in *Barclays* at H44). Finally, the Solicitor General acknowledges, for reasons set forth in his amicus brief filed at an earlier stage of the *Barclays* case, that "the analysis and holdings of the California Supreme Court are subject to serious question." *Id.* at 8. The Solicitor General nevertheless concludes that the recent California legislation has rendered the question of the constitutionality of worldwide combined reporting uncertworthy on the ground that the case "lacks substantial recurring importance." *Id.* at 10.

3. *The continuing significance of the issues raised by Colgate.* With all due respect to the views of the Solicitor General, we believe that his judgment as to the continuing importance of the issues raised in *Barclays*, and by Colgate

[2] All references to the Solicitor General's brief in this case are denominated "S.G. Br." followed by a page reference.

here, is misguided. In fact, the issues raised in these cases are of enormous continuing significance and, as such, warrant this Court's review.

First, the constitutionality of worldwide combined reporting raised in this case and in *Barclays* is an issue that has fueled widespread disputes between taxpayers and the State of California as illustrated by the multitude of cases currently pending in state courts and administrative tribunals. The amount of taxes at stake in these controversies is enormous. Approximately $1.2 billion in refund claims and $1.9 billion in assessments rest upon the outcome of this case alone, with an additional $500 million in refunds and $350 million in assessments resting upon the outcome of *Barclays*. *See* Report, Senate Revenue & Taxation Committee, S.B. 671 (Alquist), 1993-94 Reg. Sess., August 16, 1993.

Significantly, the Solicitor General recognizes that California's method of taxation, even after the changes in the law in 1986, is fundamentally inconsistent with federal foreign policy [3] and continues to be an irritant in relations with foreign governments. *See* S.G. Br. at 9. In fact, the Solicitor General adopts the analysis set forth in a brief filed by the United States as *amicus curiae* in *Barclays* at an earlier stage in this case. *See* S.G. Br. at 8. That brief took the position that California's method significantly interfered with federal foreign policy despite the fact that a water's-edge election was in place at that time. *Am.* U.S. Br. *Barclays*, No. 92-212, cited in S.G. Br. at 8. By implication, because that method of taxation continues through January 1, 1994, the Solicitor General concurs that California will be imposing a tax in violation of the Commerce Clause at least until that date. The recently enacted legislation does nothing to cure the continuing

[3] The importance of the worldwide combined reporting issue to the federal government, even after the 1986 California legislation, is illustrated by the highly unusual action of the U.S. in filing amicus briefs, subsequent to 1986, in California *state* courts in support of *Barclays*.

Commerce Clause violations as California, for years to come, audits multinational groups to assess and collect a tax computed in a way that the Solicitor General agrees violates the Commerce Clause.

Second, neither the recently enacted California legislation nor the Solicitor General even purports to address the due process concerns presented to this Court by the petitioner in *Barclays*. Indeed, the Solicitor General explicitly limits his comments to issues relevant to the Commerce Clause. *See* S.G. Br. at (i). By failing to address taxpayers' due process concerns, California's new legislative scheme, presented to this Court as a purported cure for the state's current unconstitutional taxing scheme, is incomplete. Foreign-based multinational taxpayers that do not elect to use the water's-edge option will continue to challenge worldwide combined reporting on the basis of the discriminatory compliance burdens imposed by that taxing scheme, and domestic-based taxpayers will continue to assert their right to equal treatment under the Commerce Clause. The Solicitor General's confidence that the issues presented in *Barclays* and this case "lack[] substantial recurring importance" (S.G. Br. at 10) therefore appears to be, at best, optimistic.[4]

In view of the large number of taxpayers that are currently disputing California's use of the worldwide combined reporting method of taxation and the significant amount of tax dollars involved, the continuing practical importance of this controversy and the need for this Court's review are self-evident.

4. *The failure of the recent California legislation to eliminate the unconstitutional burdens imposed on Col-*

[4] In addition, the issue of the constitutionality of worldwide combined reporting continues to have importance to other states' taxing systems. Even now, the State of Alaska imposes worldwide combined reporting, without a water's-edge election, on certain companies engaged in the production or transportation of oil and gas. *See* Alaska Stat. § 43-20-073 (1992).

gate. The Solicitor General is clearly in agreement with Colgate that California's current method of taxation [5] is a "source of conflict" with foreign nations and as such is constitutionally suspect. *See* S.G. Br. at 4, 8, 10. However, despite agreeing with Colgate that the "analysis and holdings" of the California Supreme Court's decisions below "are subject to serious question" (S.G. Br. at 8), the Solicitor General expresses the opinion that the new legislation enacted in California obviates the need for this Court's review of the issues raised in this case. This opinion appears to be based largely on the mistaken premise that corporate taxpayers "now have an unburdened right to be taxed on an 'arm's length' basis." S.G. Br. at 9.[6]

As discussed above, *see supra* pp. 2-3, the new legislation, due to come into effect in California on January 1, 1994, modifies the existing water's-edge legislation enacted by California in 1986. Although the new legislation removes some of the obstacles to filing on a water's-edge basis (for example, the fee, the Domestic Disclosure Spreadsheet, and the ability of the Franchise Tax Board to disregard a taxpayer's election), many of the restrictions to filing on a water's-edge basis remain. For example, the new legislation continues to require that certain foreign corporations be swept into the water's-edge group, including any Canadian or Mexican corporations

[5] The new legislation signed by the Governor on October 6, 1993, does not come into effect until January 1, 1994.

[6] The Solicitor General acknowledges that any view regarding whether the new California legislation remedies the past foreign policy interference is no more than speculation. His brief recognizes that issues "might hereafter arise in connection with enforcement of the State's new legislation." S.G. Br. at 10. The fact that the record in *Barclays*, or *Colgate*, is inadequate to address issues arising under the new legislation has no bearing on the underlying truth that the serious foreign policy and Commerce Clause concerns raised in *Barclays* and *Colgate* are not deprived of future significance by the changes in California law.

eligible for inclusion in the federal consolidated return [7] and any foreign corporation if 20 percent or more of its average apportionment factors are within the U.S. There is still, therefore, much potential for aggravating our foreign trading partners.

Indeed, perhaps the most telling evidence that the new legislation does not present "an unburdened right to be taxed on an 'arm's length' basis" is the reaction of foreign nations themselves. In an official Demarche, the Member States of the European Community and the Commission of the European Communities have notified the U.S. government that they "do not consider that the unitary tax problem is solved." *See* Demarche from the Member States of the European Community and the Commission of the European Communities, reproduced in full in App. A. Rather, the Demarche states that "[a] complete solution will require the arm's length principle to be established as the only legitimate basis of taxing foreign companies in any state" (*see* App. A at 2a) and urges the government to support *Barclays*. Clearly, California's proposed legislative solution to the problem of worldwide combined reporting will continue to cause consternation among our foreign trading partners, as the current system has done for the past twenty years. The seriousness of the international ramifications surrounding these issues makes this case worthy of this Court's review.

[7] For example, Colgate itself would be forced to include its Mexican subsidiary within any water's-edge return that it filed or to challenge that condition as a violation of the Commerce Clause.

CONCLUSION

The only constitutionally acceptable result in this case is an unfettered right to use the water's-edge method of taxation. Taxpayers currently do not have that right, nor is that right available under the new legislation. Moreover, even assuming that the Solicitor General is correct and that the new legislation does bestow an unburdened right to use a constitutionally acceptable taxing scheme, this Court should not disregard the ongoing practical importance of the issues raised by the taxpayer in this case and in *Barclays*, which demand this Court's plenary review.

Respectfully submitted,

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Dated: October 18, 1993

APPENDICES

APPENDIX A

EMBASSY OF BELGIUM

3320 Garfield Street, N.W.
Washington, D.C. 20065

Washington, September 23, 1993

The Honorable Warren Christopher
Secretary of State
Washington, D.C. 20520

Dear Mr. Secretary:

We have the honor to convey to you the attached note on unitary taxation on behalf of the Governments of the Member States of the European Community and the Commission of the European Communities.

We avail ourselves of this opportunity to renew to you the assurances of our highest consideration.

Juan Cassiers
Ambassador of Belgium
DC-Presidency

Andreas van Agt
Ambassador of the
Delegation of the
Commission of the
European Communities

UNITARY TAXATION

1. The Member States of the European Community and the European Commission have the honour to refer to their note of 26 March 1993 in which they expressed their strong opposition to worldwide unitary taxation and urged the United States Government to support the Barclays petition for certiorari to the United States Supreme Court. The Member States, together with eight other major trading partners of the United States, subsequently supported the Barclays petition in an amicus curiae brief dated 22 April 1993.

2. The Member States and the European Commission note that the State of California has since passed legislation to modify its unitary tax law. While this legislation is an improvement, the Member States and the European Commission do not consider that the unitary tax problem is solved. Worldwide unitary taxation, which is contrary to the internationally agreed arm's length principle, is still the basis of the tax system in California. A complete solution will require the arm's length principle to be established as the only legitimate basis of taxing foreign companies in any state.

3. The Member States and the European Commission therefore continue strongly to urge the United States Government to support the Barclays petition for certiorari to the United States Supreme Court.

APPENDIX B

RULE 29.1 LIST

The change to the list of Colgate's less than 100 percent owned subsidiaries since the filing of the petition for certiorari is as follows:

Subsidiary	*Ownership Interest*
Colgate Palmolive (India) Ltd.	51.00%